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THE ROLE OF THE PUBLIC SECTOR IN SPAIN: STRUCTURAL CHARACTERISTICS AND POLICY ADJUSTMENT ON THE ROAD TO THE EEC INTERNAL MARKET

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CONTENTS

INTRODUCTION

This paper discusses the main features of the Spanish fiscal and expenditure policies over the past fifteen years and briefly addresses both the adjustment efforts over the 1975-1985 period and the responses of public policy to the 'EEC cum 1992' shock.

The impressionistic analysis which follows can be succintly summarized by three basic questions. Which are the main structural characteristics of the Spanish public sector on the eve of the EEC membership? How did public policy respond to the impact of the EEC accession? What policies could be implemented as to reduce the costs associated to the fundamental economic changes envisaged for 1992? The first question is addressed in Section I. Section II will address the issue of public policy responses to the permanent shock of 1986 as well as to the challenges posed by the 1992 European Internal Market.

I. THE PUBLIC SECTOR ON THE EVE OF EEC ACCESSION

A. BACKGROUND

The last fifteen years have been characterized by an extraordinarily rapid growth in the degree of government's involvement in the Spanish economy. Against a historical background of substantial off-budget public sector intervention, which had given rise to a rich variety of rigidities and distortions, the general government expenditure initiated a steeply upward trend in the mid-seventies. As a result, while general government expenditure rose 1 percentage point of GDP per annum in the EEC in the 1975-1985 period, in Spain the public expenditure share almost doubled to reach a peak of 42.5 per cent, this corresponding to an average annual rise of some 1.8 per cent of GDP.

Two broad factors in this outstripping change of trend can be singled out. First, the decline in economic performance relative to levels experienced and anticipated in the previous decade led to a marked increase in transfers, subsidies and income maintenance expenditures. Second, the political change that ended at a democratic regime started a sort of 'catching-up process' in the welfare state area. Despite the effects of the 1977-1978 tax reform, the strenght of the foregoing driving forces outpaced the revenue potential. The tax share in GDP rose by almost 1.3 percentage points per year on average), resulting in public deficits and rising public debt. The ensuing increase in debt interest payments further compounded this difficulties by adding to government's precommitment of resources (see Table 1).

On the eve of Community membership, both the share and the role of the public sector in the Spanish economy were entirely different than they were in the mid-seventies. The initially prevailing consensus that a public sector expansion was required both to improve competitiveness and living standards and to consolidate social cohesion is now increasingly questioned, in view of the detrimental effects of some expenditure and tax programmes on resource allocation, economic incentives and international competitiveness. What has happened? How has it affected the Spanish position vis-à-vis the EEC countries? The present section briefly addresses these two questions.

TABLE 1: MAIN PUBLIC SECTOR AGGREGATES
(per cent of GDP)

	1973	1981	1983	1985	1986	1987	1988
1) TOTAL EXPENDITURES							
. EEC 10	37.2	47.1	48.6	49.0	48.4	47.9	47.4
. Spain	22.7	35.6	38.8	42.5	42.2	41.4	40.5
2) TOTAL REVENUES							
. EEC 10	36.1	41.8	43.4	43.8	43.6	43.7	43.6
. Spain	23.8	31.7	34.0	35.5	36.1	37.8	37.5
3) NONFINANCIAL DEFICIT (-)							
. EEC 10	-1.1	-5.3	-5.3	-5.2	-4.8	-4.2	-3.8
. Spain	1.1	-3.9	-4.8	-7.0	-6.1	-3.6	-3.0
4) GROSS PUBLIC DEBT							
. EEC 10	36.9	42.6	50.8	56.6	57.8	59.2	60.0
. Spain	12.8	22.7	34.5	46.6	47.6	48.1	48.5
5) DEBT INTEREST							
. EEC 10	1.9	3.7	4.4	5.0	5.1	4.9	4.8
. Spain	0.6	0.8	1.3	3.2	3.9	3.6	3.3

Sources: Comision de las Comunidades Europeas, Informe Económico Anual 1988-1989, Ministerio de Economía y Hacienda, Madrid, 1989; OECD, OECD Economic Surveys: Spain, Paris, may, 1989; Banco de España, Informe Anual 1988, Madrid, june, 1988.

B. FISCAL POLICY

The financial position of the general government worsened steadily after 1973 as the financial balance deteriorated from a superavit of 1.1 points of GDP to a deficit of 5.6 percentage points in 1982.

Most of this abrupt change in the sign of the government borrowing requirement had a structural nature. Important as it was the negative effect on public accounts of GDP growth slowdown (channeled through reduced taxes and increased transfers to firms and unemployed workers), OECD calculations[1] estimate the deterioration of the cyclically-adjusted budget balance in 3.9 percentage points of potential GDP. Discretionary increases in personal taxes (2.4 GDP percentage points) and social security contributions (4.3 GDP percentage points) together with restraint in public investment were not large enough to counterbalance the tremendous rise in social expenditures (6.0 per cent of GDP), transfers to public and private enterprises (2.9 per cent of GDP) and public consumption (3.8 GDP percentage points). On average, two-thirds of the general government borrowing requirements were financed by the Bank of Spain and the financial institutions (largely through compulsory coefficients).

Over the 1982-1985 period a number of measures were implemented with important implications as to the stance and the medium-term effects of fiscal policy. The experience of the seventies led to disillusionment with 'fine-tunning', partly because the negative effects of discretionary expansion on inflationary expectations[2] and international competitiveness, partly because the harmful impact of deficit financing upon investment[3], employment[4] and debt dynamics[5]. Recognition of the importance of improving public sector finances led to a deficit reduction of 0.6 GDP percentage points. This outcome

TABLE 2: CHANGES IN GENERAL GOVERNMENT ACCOUNTS, 1973-1985
(per cent of GDP)

	1973/77	1977/82	1982/85
I. Current revenues	3.0	5.0	3.1
1. Taxes on production and imports	-1.2	1.1	1.8
2. Taxes on income and profits	1.0	1.9	1.7
3. Social security contributions	2.8	1.5	-0.1
4. Other	0.4	0.5	-0.3
II. Current Transfers	2.7	5.3	3.5
1. Social transfers	1.9	3.6	0.9
2. Interest on public debt	-0.1	0.5	2.2
3. Subsidies	0.5	1.1	0.1
4. Other	0.4	0.1	0.3
III. Net disposable income	0.3	-0.4	-0.3
IV. Public consumption	1.5	2.3	0.6
V. Public investment	0.1	0.4	1.4
VI. Capital revenues	-0.1	0.0	0.2
VII. Capital transfers	0.3	1.0	0.1
VIII Financial deficit	1.7	5.0	1.4
Memorandum:			
Structural deficit*	-1.4	-2.7	-0.1
Bank of Spain financing	0.4	3.4	-2.2

Sources: J. Alcaide, "El gasto público en la democracia española. Los hechos". Papeles de Economía Española, 37, 1988; Banco de España, Informe Anual (Apendice Estadístico), years 1983 and 1986; J.C. Chouraqui, "Los déficit públicos en los países de la OCDE", Papeles de Economía Española, 24, 1985; own calculations.

Notes: * A minus sign indicates a movement towards expansion was achieved mainly through the operation of the built-in stabilizers, since the combined effects of a reduction in public investment (0.3 per cent of GDP) and a substantial increase in personal and indirect taxes and social security contributions (2.3 per cent of GDP) was largely offset by a continued rise in current expenditure.

Perhaps the most salient feature of the three-year period preceeding EEC accession was the change introduced by the government in 1983-1984 in financing the deficit, which shifted away from the Bank of Spain resources by means of the creation of treasury bills (Pagarés del Tesoro). However, the beneficial allocational effects of orthodox deficit financing turned more difficult the attainment of the objective of halting the deterioration of the government deficit, which increased by 0.7 percentage points of GDP to 5.5 percent of GDP in 1984.

The rapid increase in the share of current expenditure allocated to interest payments (2.2 points of GDP) obscured the efforts made to decelerate public expenditure growth. Thus, despite the increase in the tax burden and an important reduction in the rate of growth of social expenditures and transfers to enterprises, which put a stop to expansion in the structural deficit, the overall government borrowing requirement rose to an unprecedented 7.0 per cent of GDP. At the end of 1985, the share of public debt in GDP reached 46.6 per cent, a figure that trebbled the 1979 share.

C. PUBLIC EXPENDITURE POLICIES

Economic expenditure categories

In the early seventies, the share of general government expenditure in GDP was below the EEC average by 14.5 points (see

Table 1). Expansion in public expenditure has been quite uneven across economic components. As Table 2 shows, current transfers have been the most rapidly growing expenditure item, at an annual average rate of 1.0 per cent of GDP. Transfers to families and firms and unemployment benefits account for most of the expansion in the 1973-1982 period. Interest payments played this leading role over the three-year period ending in 1985.

Growth of public consumption was more moderate (0.4 GDP percentage points per annum). Wages accounted for the largest part of the rise in public consumption. National accounts indicate, however, that the relative price effect of current consumption was weak by the end of the seventies and even turned negative during the eighties[6]. This phenomenon reflects significant wage moderation, since the share of public salaries in GDP grew by more than 60 per cent between 1973 and 1985, while the number of employees working in the public sector almost doubled.

In the seventies, public investment played the role of escape valve of the pressures for fiscal restraint. As a result, the share of public fixed investment in GDP fell almost continuously until the early eighties. In the same lapse, total capital expenditure share rose due to substantial increases in capital transfers. In 1982, the share of public investment picked up strongly, doubling in a five-year period to surpass the average European public investment share in GDP.

Broad trends in major expenditure functions

The changes in the structure of general government expenditures are summarized in Table 3. Four major government functions are distinguished: public goods, merit goods, income maintenance

TABLE 3: THE STRUCTURE OF GENERAL GOVERNMENT EXPENDITURE
BY FUNCTIONAL COMPONENTS
(per cent of GDP)

	1970	1975	1980	1982	1985	1986	1987
I. Public Goods	4.3	4.6	5.3	5.6	6.1	6.3	6.2
(1) Defence	1.7	1.7	2.0	2.0	2.0	2.3	2.2
(2) General Public Services	2.6	2.9	3.3	3.6	4.1	4.0	4.0
II. Welfare State	13.0	16.2	21.6	22.8	24.8	24.5	24.5
(3) Merit Goods	5.6	6.9	8.9	8.7	9.9	9.8	10.0
. Education	1.9	2.1	3.3	3.0	3.6	3.6	3.6
. Health	2.8	3.8	4.5	4.3	4.5	4.4	4.4
. Housing and Colective Services	0.9	1.0	1.1	1.4	1.8	1.8	2.0
(4) Income Maintenance	7.4	9.3	12.7	14.0	14.9	14.6	14.5
. Pensions	4.0	5.6	8.6	9.2	10.0	9.9	10.0
. Unemployment Compensation	0.2	0.5	2.2	2.6	2.9	2.9	2.7
. Other	3.2	3.2	1.9	2.2	2.0	1.8	1.8
III. Mixed Economy	4.8	4.2	6.2	9.3	11.6	11.8	11.4
(5) Economic Services	4.2	3.7	5.5	8.3	8.4	7.7	7.7
. Investment	2.3	2.1	1.6	2.8	2.9	2.8	2.9
. Subsidies and Transfers	1.9	1.6	3.9	5.5	5.5	4.9	4.8
(6) Public Debt Interest	0.6	0.5	0.7	1.0	3.2	3.9	3.6
TOTAL EXPENDITURE	22.1	24.9	33.1	37.7	42.5	42.4	42.0

Sources: Fundacion FIES-CECA, on the basis of data from Contabidad Nacional de España (Instituto National de Estadística) and Cuentas de las Administraciones Públicas (Intervención General de la Administración del Estado).

and economic services. Public goods are intended to meet collective needs and represent the traditional domain for public intervention in the economy (national defense and general public services). Merit goods (education, health, housing and collective services) can in principle be provided through the market. Public involvement in this area seeks justification on categorical equity grounds (equality of opportunity, social cohesion and other non-economic objectives). Income maintenance outlays (pensions, unemployment compensation, sickness benefits and family allowances) have the major purposes of cushioning people against income loss while preventing both poverty and specific market failures (externalities, moral hazard and the like). Finally, government 'mixed economy' interventions include the provision of economic services (infrastructure, subsidies, capital transfers and other outlays) for allocation purposes and the interest costs of deficit financing.

Over the 1975-1982 period the big expansion of government occurred in the welfare state area, as it was the case of most OECD countries[7]. Expenditure on merit goods and income maintenance rose by 6.6 percentage points to 22.8 per cent of GDP in 1982. Within the merit goods category, the fastest growing item was education (43 per cent of relative increase in its GDP share), followed by housing (40 per cent on increase) and health (13 per cent). Income maintenance expenditure showed more dynamism in this seven-year period (50 per cent of increase). Much of this was due to the growth of pension expenditures, which rose by 3.6 per cent of GDP. The share of GDP devoted to unemployment payments fivefolded between 1975 and 1982. Expenditure in the remaining income maintenance categories -mostly family allowances- suffered a drastic reduction of 1 full percentage point of GDP which halved their share in total general government expenditure.

While in most developed countries expenditure on public

Behavior of the share of education expenditures in GDP reflect both an extension of coverage -particularly in non-compulsory levels- and a sharp increase in the number of teachers in public schools[9]. The later grew by 74 per cent to a payroll of 271 thousand teachers in 1985. Significant increases in the number of pupils in post-compulsory education, both general (BUP, with a 51 per cent growth) and professional (FP, with a 142 per cent rise), explain a 30 per cent increase in the enrollment rate for 15-year-olds. Increases in the number of pre-primary pupils (22 per cent) and university students (48 per cent) contributed as well to the observed rise in the share of education expenditures in GDP between 1975 and 1985.

The upward trend experienced by the share of expenditure on housing over the 1975-1985 period can be attributed to the consequences of the new legislation on housing policies passed in 1978 and the ensuing 'housing plans' of 1981-1983 and 1984-1987. Under these programmes -intended to reduce the housing deficit while ensuring equal access through personal allowances and housing subsidies as well as to boost economic activity in the construction sector- 733.7 thousand houses were built. Results of this new housing policy have not been particularly brilliant as to the number of finished houses per year over the 1981-1985 period, which was roughly in line with public housing achievements of the 1975-1980 period. Indeed, however, public finance played a more prominent role after the 1978 legislation[10].

Health expenditure experienced a very modest increase between 1975 and 1985. This outcome may be largely attributed to an institutional explanation. Prior to 1986, State transfers to the social security health services were given without earmarking. Efforts to provide resources for expansion of the pension benefits resulted in a restraint of health expenditure, whose share in GDP did not change over the 1980-1985 period. Real benefits per health user have been the key factor behing the rise in the volume of health expenditure between 1975 and 1985. Increased coverage also contributed significantly to the expansion of real health outlays[11].

Role of economic services and infrastructures

As noted above, trends of public expenditure in public services over the years 1975 to 1985 represent a noticeable departure from what it may be observed for other developed countries in the same period of time. The information in Table 4 provides some help in explaining why did the share of these expenditures in GDP more than double in the sort period of one decade.

Following the first oil shock, gross public investment started a decline that was to be reversed only after 1981. Leaving aside the increased investment resources allocated to provision of general public services, the share in GDP of investment in education, agriculture, and transport and communications remained stable -despite compelling needs of infrastructure improvement- and the share of investment in health, housing and other sectors actually declined through the 1976-1981 period. After substantial investment increases in 1982 and 1985, capital resources channeled to most sectors of public involvement experienced rises (with the outstanding exception of health), particularly so in housing and transport and communications. Investment in these sectors doubled its share in GDP. Importance of this pick up can be enhanced by noting that it rose the share of public investment in GDP above the EEC-4 average. However, it remains doubtful that these isolated efforts did effectively narrow gaps with respect to Community standards (see below).

Regarding the role of the public sector in the provision

TABLE 4: GENERAL GOVERNMENT EXPENDITURE ON GROSS FIXED INVESTMENT AND ECONOMIC SERVICES IN 1985: EEC 4 AND SPAIN (per cent of GDP)

	EEC 1985					SPAIN		
	Germany	France	Italy	U.Kingdom	EEC 4	1976	1981	1985
GROSS FIXED INVESTMENT	2.3	3.2	3.8	2.0	2.7	2.3	2.1	3.6
1. General Public Services						0.1	0.2	0.4
2. Education						0.3	0.3	0.4
3. Health						0.3	0.2	0.2
4. Housing						0.5	0.4	0.9
5 Agriculture						0.3	0.3	0.4
6 Transport and Communications						0.4	0.4	0.8
7. Other						0.4	0.3	0.5
ECONOMIC SERVICES	3.9	3.9	7.4	4.4	4.8	3.2	4.6	6.6
A) Economic Sector								
1. Energy and Gas	0.3	0.4	0.4	0.4	0.3	0.2	0.2	0.4
2. Agriculture	0.2	0.3	0.8	0.5	0.4	0.9	1.2	1.2
3. Mining and Industry	0.1	0.1	1.1	0.1	0.3	0.3	0.7	1.2
4. Transport and Communications	2.1	1.5	3.8	2.0	2.3	1.4	2.0	2.8
5. Other	1.2	1.6	1.3	1.4	1.4	0.4	0.5	1.0
B) Type of Operation								
1. Subsidies						1.1	1.3	2.0
2. Capital Transfers						0.5	1.2	1.7
3. Fixed Investment						0.8	0.7	1.3
4. Wages						0.4	0.6	0.6
5. Other						0.4	0.8	1.0

Sources: M. Lagares, R. Alvarez, I. Encabo, J.M. González-Páramo and J.L. Raymond, Niveles de Cobertura del Gasto Público en España, Fundación FIES-CECA, mimeo, july, 1988; own calculations.

of economic services, information in Table 4 allows to establish two observations. First, expenditures in transport and communications and mining and industry explain two-thirds of the increase in the share of economic services in GDP. Second, the preferred method for expanding public involvement in these sectors was the provision of capital transfers and subsidies to both public enterprises and ailing industries under the industrial restructuring programmes initiated in the early eighties.

Government expenditures vis-à-vis the 'EEC Standard'

Table 5 shows the structure of general government expenditure in the largest four EEC countries (EEC-4) and in Spain in 1985. Italy stands out as the country with the closest resemblance to Spain in respect of the role of the public sector. A high share of expenditure in economic services and the relatively low shares in social security and housing relative to the EEC-4 averages are shared in common by Italy and Spain.

Casual comparisons, however, cannot help to throw light on the question of where may Spain lag behind -and where it may already be ahead- of the EEC countries. Once it is recognized that each expenditure category has its own socio-economic and demographic determinants, it should be an acceptable conclusion that comparisons on the 'adequacy' of Spanish public expenditure priorities with respect to EEC averages need to be corrected for socio-economic and demographic differences existing between Spain and the EEC countries.

This 'standardized comparison' can be made as follows[12]. Let Y_{ij} be the j-th expenditure share of country i, i: Federal Republic of Germany, France, Italy and the United Kingdom. Estimate an equation for every expenditure category using as explanatory variables the

TABLE 5 : THE STRUCTURE OF GENERAL GOVERNMENT EXPENDITURE IN 1985: EEC 4 AND SPAIN
(in per cent of GDP)

	Germany	France	Italy	U. Kingdom	EEC 4	Spain
1. General Public Services	4.4	4.3	4.4	4.1	4.3	4.1
2. Defence	2.9	4.0	2.0	5.0	3.5	2.0
3. Education	4.7	6.4	5.5	5.6	5.5	3.6
4. Health	6.0	6.9	5.5	4.9	5.9	4.5
5. Social Security	19.7	22.1	15.9	13.8	18.2	14.9
6. Housing	1.0	3.2	1.5	3.2	2.2	1.8
7. Other Social Services	0.7	1.1	0.3	-	0.6	0.9
8. Economic Services[1]	3.9	3.9	7.4	4.4	4.8	6.6
9. Other[2]	3.0	2.2	6.8	4.8	4.0	4.0
TOTAL EXPENDITURE	46.5	54.1	49.5	45.9	48.9	42.5

Source: M. Lagares, R. Alvarez, I. Encabo, J.M. González-Páramo and J.L. Raymond, Niveles de Cobertura del Gasto Público en España, Fundación FIES-CECA, mimeo, july, 1988.

Notes: 1 Includes: energy, gas, agriculture, mining, industry, transport, communications and other services.

2 Public debt interest, among other minor expenditures.

appropriate socio-economic and demographic variables:

$$Y_{ij} = G_j(X_{ijk}) ,$$

where k is an index for the determinants of the observed behavior of Y_{ij}. Now use the observed socio-economic and demographic data of Spain (i: o) to obtain:

$$Y^*_{oj} = G_j(X_{ojk}) .$$

Finally compare actual expenditure shares, Y_{oj}, with predicted shares, Y^*_{oj}.

Table 6 shows the results of this exercise for the years 1976, 1981 and 1985. As regards total expenditure, Spain has converged toward the 'EEC Standard' on a stable and sustained fashion. Trends in individual expenditure components have been diverse. In 1985 Spain lagged behind the EEC 4 in national defense, education, housing, health and social security. On the contrary, it was ahead in general public services, 'other' (interest payments on public debt essentially), economic services and 'other social services' (museums, press and information, radio, television, cinematography, theatre, music and other cultural services).

These indications of 'need' can be further complemented with a selection of social policy and infrastructure indicators such as those arranged in Tables 7 and 8. The distances shown up by the indicators relevant to education, health, housing, unemployment, pensions and, above all, infrastructure, do not require further comments.

Decentralization of government expenditures

The Spanish general government sector consists of three main agents: the Central Government, the Social Security System and

TABLE 8: SELECTED INFRASTRUCTURE INDICATORS
IN THE E.E.C. AND SPAIN
(circa 1985)

		Germany	France	Italy	U. Kingdom	Spain
(1)	Length of road networks (thousand kilometers)	492.8	801.4	297.0	370.9	167.2
(2)	Road kilometers per thousand vehicles	18.4	33.8	13.1	19.3	16.3
(3)	Length of motorways (thousand kilometers)	7.8	5.7	5.7	2.9	2.0
(4)	Motorway density (kilometers per square kilometer of land)	30.0	9.7	19.7	10.8	3.8
(5)	Private vehicles per thousand capita	412.0	340.0	366.0	304.0	229.0
(6)	Passengers-kilometer by train (billion)	38.4	60.3	37.1	30.1	15.6
(7)	Passengers-kilometer by aircraft (billion)	24.4	32.8	13.6	43.6	16.5
(8)	Telephone sets per hundred capita	60.0	60.0	43.0	52.0	36.0
(9)	Total factor productivity change in postal services (per cent)	2.6	-0.2	-1.0	5.1	-6.0
(10)	Public expenditure in transport and communications per square kilometer of land (1985 PPP Ecu)	6956	1820	7103	4875	1189

Source: Eurostat, Estadísticas Básicas de la Comunidad, Luxemburgo, 1987; United Nations Organization, Statiscal Yearbook 1984, New York, 1986; S. Perelman and P. Pestieau, "Technical performance in public enterprises: A comparative study of railways and postal services", European Economic Review, 32, 1988, pp, 432-441; M. Lagares, R. Alvarez, I. Encabo, J.M. González-Páramo and J.L. Raymond, Niveles de Cobertura del Gasto Público en España, Fundación FIES-CECA, mimeo., july, 1988; own calculations.

the Territorial Governments. The subnational public administrations are Regional Governments (Autonomías) and Local Authorities (Provincias and Municipios). Most of the Territorial Governments' resources come from State transfers through three channels: unconditional automatic transfers, transfers from an 'Interterritorial Compensation Fund' and government funds for earmarked purposes.

On the eve of enactment of the Constitution, the Territorial public sector's share in general government expenditure was very small. Since 1978 it has been continuously increasing, slowly at first, but quite rapidly after 1981. Between 1981 and 1985, the share of Territorial Governments in total public expenditure increased 10 percentage points to 21.4 per cent (see Table 9). In 1985, the lower levels of government were accounting for the most part of total expenditures in housing, education, investment and other social services, and incresing responsibilities were being taken in the provision of health care.

Further issues: Expenditure control and deficit spending

As regards to the rapid increase of public expenditure over the 1975-1985 period, two factors may be singled out as having exerted a negative influence upon the assessment of spending needs. First, there exist identified budgetary practices that made it easy for spending departments to claim more resources than the amount approved in the budget[13]. Among these are the following: 1) Special cash facilities ('anticipos') are available from the central bank up to a limit of 12 per cent of total budget appropriations[14]; 2) Initial budget plans tend to be widely exceeded by total final credits due to laxity in the concession of supplementary credits by the Parliament (these have averaged 13 per cent of initial appropriations over the first half of the eighties[15]); 3) Unused

TABLE 9: DECENTRALIZATION OF GENERAL GOVERNMENT EXPENDITURE
(in per cent of total expenditure)

	1976		1981		1985	
	Central[1] Govt	Territorial[2] Govts	Central[1] Govt	Territorial[2] Govts	Central[1] Govt	Territorial[2] Govts
1. General Public Services	76.1	23.9	72.5	27.5	68.6	31.4
2. Defence	100.0	0.0	100.0	0.0	100.0	0.0
3. Education	96.2	3.8	86.2	13.8	45.2	54.8
4. Health	93.8	6.2	91.9	8.1	87.0	13.0
5. Social Security	96.7	3.3	97.0	3.0	96.1	3.9
6. Housing	50.4	49.6	50.1	49.9	19.0	81.0
7. Other Social Services	37.3	62.7	50.6	49.4	23.9	76.1
8. Economic Services	87.8	12.2	89.0	11.0	72.7	27.3
9. Other	83.0	17.0	75.3	24.7	83.8	16.2
TOTAL EXPENDITURE	89.7	10.3	88.6	11.4	78.6	21.4

Sources: M. Lagares, R. Alvarez, I. Encabo, J.M. González-Páramo and J.L. Raymond, Niveles de Cobertura del Gasto Publico en España, Fundación FIES-CECA, mimeo, july, 1988; own calculations.

Notes: 1 Includes Central Administration and Social Security

2 Includes Regional Governments (Comunidades Autónomas) and Localities (Municipios).

appropriations resulting from a relatively low degree of realization of final credits (90 per cent on average) can be carried forward subject to some limitations. These practices, compounded by the lack of efficiency reviews and the failure of the modernization programme for expenditure management set in train in 1983[16], have emptied the budget institution of its nature as a means to constrain and allocate public expenditure[17].

In the second place, the deficit itself may have caused or facilitated increases in public expenditures larger than would have obtained otherwise. Causality analysis has shown causation from deficit finance to government expenditure[18]. Government's power to print money and issue debt as an alternative to raising taxes has been used to overcome taxpayer's resistance, making it easier to expand public spending at the cost of increased future taxes and/or future spending reductions. Empirical analysis attributes to deficit spending about one-fourth of the increase in the share of general government expenditure in GDP between 1975 and 1986.

D. TAX POLICIES

The 1977-1978 tax reform

The tax system operated by the government in 1975 exhibited two salient features. On the one hand, the total tax ratio (fiscal pressure) was well below the EEC average. As Table 10 shows, total tax revenues amounted 21.6 per cent of GDP, 13.1 percentage points less than the EEC average (excluding Spain) and one-half of the total tax ratio in the highest tax country (Netherlands). Only Greece, Portugal and Italy had comparable tax ratios.

On the other hand, the structural characteristics of

TABLE 10 : GENERAL GOVERNMENT TAX REVENUES
(per cent of GDP)

EEC 1975-86

	1975	1980	1985	1986
Belgium	41.1	43.5	46.6	45.4
Denmark	41.4	45.5	48.7	50.6
France	36.9	41.7	44.5	44.2
Germany	35.7	38.0	37.9	37.5
Greece	24.6	28.6	35.2	36.7
Ireland	31.5	34.0	39.0	40.2
Italy	25.1	30.0	34.7	36.2
Luxembourg	39.2	40.9	42.9	42.4
Netherlands	43.9	45.8	45.1	45.5
Portugal	24.7	28.7	31.5	32.4
United Kingdom	35.4	35.3	38.1	39.0
EEC[1]	34.7	37.0	39.8	40.1

SPAIN 1975-1988

1975	1980	1985	1986	1987	1988
21.6	26.9	31.5	32.7	34.6	34.3[2]

Sources: OECD, Revenue Statistics of OECD Member Countries, 1965-1985, Paris, 1988; Fundación FIES-CECA, Cuadernos de Información Económica, 20, december, 1988.

Notes: 1 Weighed average excluding Spain (1985 GDP weights and exchange rates)

2 Estimate (Fundación FIES-CECA)

the tax system were such that made it unsuitable to contribute to the modernization of the economy that was to come. As Table 11 shows, almost one-half of tax revenues came from social security contributions, nearly 30 per cent were provided by indirect taxes and less than 20 per cent came from personal and corporate taxes. Prominent among indirect taxes was a cascading-type tax on business turnover (Impuesto sobre Tráfico de Empresas), which plagged domestic transactions with non-neutralities and distorted the pattern of external trade. Personal income taxes were levied by means of a 'mediterranean-style' cedular system: cedular taxes worked as minimum levies that taxed independently different sources of income. Presumptive tax base determination was widely used. High-income taxpayers were liable to a so-called 'general income tax', a progressive tax on gross income against which cedular taxes paid could be credited[19].

Taken as a whole, the tax system inherited from the 1964 reform scored poorly with regard to the most basic principles of taxation. Practical absence of personalization elements and rigidity of tax bases made it unlikely that the tax system could be of much help in financing public policies while preserving sufficiency, equity, neutrality and flexibility. Further, the tax system that was in place in the mid-seventies was seen as an important obstacle in the process of convergence towards integration in the EEC.

Urged by the strength of social pressures for expenditure increases, tax reform became a top priority in the political agenda simultaneous with the change of political regime. In November 1977 a number of exceptional measures were adopted to increase revenues (surtaxes on business profits, highest personal incomes and luxury goods), while signaling the government's purpose of overhauling the tax system and changing attitudes towards compliance ('tax amnesty', abolition of confidentiality in bank operations, creation of an

TABLE 11: STRUCTURE OF TAX BY SOURCE
(per cent of total tax revenues)

	EEC	SPAIN					
	1985	1975	1980	1985	1986	1987	1988
(1) Income Taxes	33.8	18.5	22.2	23.6	22.5	27.9	28.2
. Personal	26.5	12.6	17.6	18.5	17.0	21.1	21.6
. Corporate	7.3	5.9	4.6	5.1	5.5	6.8	6.6
(2) Social Security Contributions	29.7	46.1	48.7	41.7	40.4	38.4	37.9
(3) Property Taxes	4.0	3.5	4.3	4.1	3.8	3.1	3.8
(4) Consumption Taxes	29.8	27.7	18.1	24.3	30.3	27.8	27.5
. General	16.3	12.9	6.5	11.9	17.2	15.9	15.8
. Excises	13.5	14.8	11.6	12.4	13.1	11.9	11.7
(5) Other taxes	2.7	4.2	6.7	6.3	3.0	2.8	2.6

Sources: OECD, Revenue Statistics of OECD Member Countries, 1965-1987, Paris, 1988 (for EEC 1985); Instituto Nacional de Estadística, Contabilidad Nacional de España, 1970-77, Madrid, 1981 (for Spain 1975); Banco de España, Informe Anual 1987, Madrid, May, 1988.

'extraordinary net wealth tax' and introduction of heavy penalties against 'fiscal crime').

One year later, the Parliament passed the new personal income tax and corporate tax laws, enacted in January 1979, altogether with the elimination of cedular taxes, which were partly transferred to the local governments. The new income tax was a modern global (synthetic) progressive tax on net income accruing to family members. Allowances were granted to provide for family size, other personal characteristics and tax incentives. The reformed corporation income tax was structured in line with profits taxes operated in European countries. Changes in the indirect tax legislation were relatively less marked.

Broad trends in taxation

All in all, the 1977-1978 tax reform improved the buoyancy of the tax system as a whole. The estimated tax elasticity rose from 1.11 in the 1970-1977 period to 1.22 in 1978-1985[20]. As a result of the tax reform provisions, the share of current income and wealth taxes in GDP rose to 8.5 percentage points, doubling the 1975 figure. The overall tax ratio grew by 1.0 percentage GDP points per annum on average, twice as fast as taxes grew both in the 1965-1975 years and in the EEC (average) between 1975 and 1985. Notwithstanding, this acceleration did not prove large enough to finance the huge public spending increases that took place in the same period.

As regards to taxes other than income taxes, social security contributions kept in pace with growth in total taxes until 1980, stabilizing their share in GDP thereafter. Indirect taxes fell both as a proportion of total taxes and in their share in GDP between 1977 and 1979, strongly recovering afterwards. Overall, changes in

TABLE 12: ANNUAL AVERAGE CHANGES IN TAXES, 1975-1985
(per cent of GDP)

		1975/77	1977/80	1980/85
(1)	Taxes on Personal Income	0.1	0.7	0.3
(2)	Taxes on Corporate Income	-0.1	0.0	0.1
(3)	Social Security Contributions	0.8	0.5	0.0
(4)	Taxes on Productión	0.1	0.1	0.5
(5)	Taxes on Imports	0.0	-0.4	0.0
(6)	Other	0.3	-0.0	-0.1

Sources: OECD, Revenue Statistics of OECD Member Countries, 1965-1987, Paris, 1988.

tax structure and tax trends led general government revenues more close to EEC standards. In 1985, the Spanish total tax ratio was 20 per cent lower than the EEC average, one-half of the relative gap that was observed ten years earlier. Though still higher (lower) than the EEC average, the share of social security contributions (income taxes) in total tax revenues decreased (increased) by almost 7 percentage points over the 1975-1985 period. The share of consumption taxes is broadly in line with the EEC average.

The main taxes in 1985

On the eve of EEC membership, the personal income tax was levied on family income at rates rising to 66 per cent, with total tax limited to 46 per cent of the tax base. The income base included labor, business and capital income (including imputed housing rent and capital gains), as well as most transfers (sickness and unemployment benefits were the most noticeable exceptions). Deductions included a basic allowance of 1 per cent of earned income, social security contributions paid by employees and interest related to a source of income. There existed extensive credits based on family circumstances, residential investment, medical expenses, insurance and life assurance premiums, dividend income (providing modest partial integration of corporate and personal tax) and a range of other expenses and investments. Provisions for automatic inflation adjustment did not exist. From 1982 to 1984 there were attempts to increase the effective progressivity of the income tax by steepening the rate structure.

Corporate income tax was levied at a rate of 35 per cent. There was no inflation relief for inventories and LIFO was not accepted by the tax authorities. Accelerated depreciation was allowed for certain assets, and there were tax credits for many investments and employment creation. Investment tax credits equaled 15 per cent of the cost of investment. Tax expenditure for job creation amounted to half a million Ptas. per job. The revenue cost of both tax credits totalled more than one-third of the 1985 tax bill.

Social security contributions were assessed on wages between prescribed limits at a usual rate of 36.4 per cent (30.4 per cent on employers and 6 per cent on employees). Contribution rates on employers were among the highest in the EEC. Since 1980, social security reform has cut contribution rates and reduced dispersion, partly by broadening the base.

Tax rates of the cascading-type tax on gross sales ranged from 0.5 per cent (wholesale commerce) to 6 per cent (electricity), with a most common rate of 4 per cent. Local surcharges were levied at rates between 0.2 per cent (wholesale trade) and a standard surtax of 1 per cent.

II. THE '1986 CUM 1992' SHOCKS: CHALLENGES AND POLICIES

A. POLICY RESPONSES TO THE EEC SHOCK

Fiscal policy

The integration of Spain in the EEC in 1986 -a relatively low-inflation area- and the large deterioration of the public finances occurred in 1985 demanded from the economic authorities a change in the stance of fiscal policy. While 1985 fiscal events represented a major setback in the efforts to improve public sector finances initiated in 1983, 1986 witnessed a return to the trend of lower budget sector deficits and reduced borrowing requirements.

As Table 13 shows, over the years 1986 and 1987 revenues increased faster than previously, due mostly to rises in direct taxes. On the other hand, for the first time since 1966 the share of current transfers in GDP experienced a reduction, an outcome attributable to both the action of automatic stabilizers (unemployment benefits and subsidies) and to the effects of the 1985 reform of the pension system. As a result of these trends, public sector disposable income increased markedly (3.8 per cent of GDP in the 1986-1987 period). Moderate increases in public consumption made possible a sharp improvement in gross savings from a negative 2.6 per cent of GDP in 1985 to a positive 1.4 per cent of GDP in 1987.

The set of fiscal policy indicators arranged in Table 14 shows that resumption of the trend toward greater fiscal restraint observed in 1986 was strenghthened in 1987. Improvements in tax collection and administration (partly attributable to the introduction of VAT) and control exerted over current expenditures and public investment explain reductions in the cyclically-adjusted deficit of 1.1 per cent of potential GDP in 1986 and 1.4 per cent of potential GDP in 1987. Reduction of the nonfinancial deficit in 1986 and the strong expansion of economic activity explain the observed reductions in the primary deficit (elliminated through 1987) and the remarkable cut-off of the nonfinancial deficit in 1987 to 3.6 per cent, half of its size two years back.

Fiscal developments in 1988 were somewhat mixed. Despite the reductions in nominal tax rates and the increase in the exemption level of the income tax, the combined effects of a stronger-than--anticipated growth and the inflationary fiscal drag[21] turned the projected fall of the direct tax ratio into a slight reduction. Extra

TABLE 13: GENERAL GOVERNMENT OPERATIONS
(per cent of GDP)

	1985	1986	1987	1988
CURRENT REVENUES	34.5	35.6	37.3	36.8
Taxes on Production and Imports	9.6	10.7	10.3	10.0
Taxes on Income and Wealth	8.5	8.3	10.3	10.0
Social Security Contributions	13.2	13.0	13.0	12.7
Other	3.2	3.6	3.7	3.7
CURRENT TRANSFERS	22.5	22.1	21.4	20.9
Social Security Benefits	14.9	14.6	14.4	14.2
Interest on Public Debt	3.3	3.8	3.6	3.3
Subsidies	2.6	2.1	1.7	1.8
Other	1.7	1.6	1.7	1.6
NET DISPOSABLE INCOME	12.0	13.5	15.8	15.9
PUBLIC CONSUMPTION	14.0	14.0	14.4	14.2
Wages	10.7	10.5	10.4	10.4
Net Purchases	2.7	2.9	3.4	3.2
Fixed Capital Depreciation	0.6	0.6	0.6	0.6
CAPITAL REVENUES	0.4	0.5	0.5	0.7
CAPITAL TRANSFERS	2.3	2.4	2.0	1.8
PUBLIC INVESTMENT	3.7	3.7	3.6	3.7
NET BORROWING (DEFICIT:-)	-7.0	-6.1	-3.6	-3.0
Memorandum:				
Total Taxes	31.5	32.1	33.7	33.4
Total expenditures	42.5	42.2	41.4	40.5
Gross savings	-2.6	-0.5	1.4	1.7

Source: Banco de España, Informe Anual (years 1987 and 1988), Madrid, 1988 and 1989.

TABLE 14: GENERAL GOVERNMENT OPERATIONS:
SELECTED FISCAL POLICY INDICATORS
(per cent of GDP)

	EEC		SPAIN				
	1985	1988	1980	1985	1986	1987	1988
(1) Total receipts	43.8	43.6	30.0	35.5	36.1	37.8	37.5
(2) Total outlays	49.0	47.4	32.6	42.5	42.2	41.4	40.5
(3) Nonfinancial deficit (-)	-5.2	-3.8	-2.6	-7.0	-6.1	-3.6	-3.0
(4) Gross public debt	56.6	60.0	17.7	46.6	47.6	48.1	48.2
(5) Debt interest payments	5.0	4.8	0.7	3.2	3.9	3.6	3.3
(6) Primary deficit (-) [1]	-0.2	0.1	-1.9	-3.8	-2.2	0.0	+0.3
(7) Deficit required for stability [2]	-2.5	-2.7	-0.6	-2.0	-2.2	-2.2	-2.3
(8) Cyclically-adjusted deficit (-) [3]	-3.3	-3.2	-1.2	-4.6	-3.5	-2.1	-2.4
(9) Change in nonfinancial deficit [4]	+0.1	+0.4	-0.2	-2.2	+0.9	+2.5	+0.6
(10) Change in cyclically-adjusted deficit [4]	+0.4	-0.2	-0.1	-0.9	+1.1	+1.4	-0.3
Memorandum:							
GDP growth	2.5	3.5	1.2	2.3	3.3	5.5	5.3
Inflation	5.9	3.5	15.6	8.2	8.7	5.4	5.1

Sources: OECD, Economic Outlook, 40 and 44, Paris, 1986 and 1988; OECD, OECD Economic Surveys: Spain, París, may, 1989; Comisión de las Comunidades Europeas, InformeEconómico Anual 1988-89, Ministerio de Economía y Hacienda; Banco de España, Informe Anual 1988, Madrid, june 1989; own calculations.

Notes: 1 Line (3) minus line (5).

2 Calculated as the net debt ratio multiplied by g/(1+g), where g is the nominal medium-term growth rate of GDP. This figure gives the deficit required for stabilization of the debt ratio at a given year's level in an economy growing at its medium-term growth ratio under the current tax laws and spending plans (g takes values of 0.07 for the EEC and 0.08 for Spain).

3 Per cent of potential GDP (1985 GDP weights and exchange rates).

4 Year-to-year changes (a positive sign indicates a movement towards restriction).

receipts -which remained stable as a share of GDP due to the economic boom- were used to finance extra expenditures. Current subsidies actually increased their share in GDP and capital transfers overshot the budget target, increasing over 21 percentage points with respect to the 1987 outcome. Public investment and public consumption remained stable at their 1985 GDP shares.

All in all, the outturn of the 1988 fiscal policy was an increase in the cyclically-adjusted deficit of 0.3 per cent of potential GDP. The observed reduction in the nonfinancial deficit was entirely attributable to the operation of built-in stabilizers. Perspectives for 1989 are of a likely continuation of the pro-cyclical stance of fiscal policy. Unexpected fiscal events -unconstitutionality of income accumulation under the personal income tax rules, with a projected fiscal cost of 210 billion Ptas.; restructuring of expenditure in favor of pensions and unemployment benefits adopted as a consequence of a general strike in December; reduction by half of social security contributions for new permanent job creations; and a continued rise of interest rates well above the Budget projections) and the expected expenditure increases along the lines of the 1989-1992 macroeconomic and budget scenario, coupled with a likely increase in the deficit of Territorial governments, make it difficult to reduce general government deficit below 3 per cent of GDP as projected in the 1989 Budget. In any case, even if recent developments have a negligible impact, the public sector structural deficit is projected to increase in 1989 by an amount comparable to that of 1988[22].

Taxation

The most noteworthy tax event of 1986 was the introduction of the largely-harmonized consumption-type European VAT. It replaced a complex and distortionary set of gross turnover taxes (Impuesto sobre Tráfico de Empresas, Impuesto de Lujo and other minor taxes). VAT has a standard rate of 12 per cent (the lowest standard rate in the EEC). Necessities and luxuries are taxed at rates of 6 and 33 per cent, respectively.

Although estimates indicate that introduction of VAT added about two percentage points to the rate of inflation, its overall impact has been highly beneficial. Neutrality in external trade has been substantially improved, double taxation of investment has been abolished and the economy's taxable base has been greatly expanded both directly and through the cross-check control of economic transactions. As a result of VAT introduction, indirect tax revenues grew by almost 33 per cent in 1986, which represented 1.1 additional percentage points in GDP. Loss of buoyancy of indirect taxes in 1987 and 1988 may be attributed to the reduction in import taxes, the fall in oil-product prices and the increased VAT contributions to the EEC Budget.

Excise taxes experienced important changes with the EEC membership. While some excises were simply abolished (Impuesto de Lujo, Renta del Monopolio de Tabacos and other minor levies), other suffered legal reform to make the overall indirect tax structure comparable to those existing in EEC countries and the average level of tariffs was halved by January 1989.

Abolition of frontier controls in 1992 will require substantial convergence of tax rates of both VAT and excises. The comparatively low shares in GDP of VAT and excises in Spain (40 and 80 per cent of the EEC averages, respectively[23]) provides some room for future tax increases. Elimination of barriers to capital movements in the Internal Market will require additional tax reform efforts in other areas, such as capital income taxation and social security financing (see below).

Public expenditure and the EEC Budget

Spain's accession to the EEC has brought two interesting novelties relevant to public expenditure practices. First, in 1986 the Spanish economy became a contributor to/beneficiary from the EEC Budget. Second, the creation of the Internal Market in 1992 has been a factor behind the introduction of medium-term objectives in year-to-year budgetary plans (Macroeconomic and Fiscal Scenario 1989--1992).

Table 15 shows the nature of the bilateral financial flows between Spain and the EEC over the 1986-1989 period. Contributions by Spain have not increased the deficit of the general government sector due to a slightly favorable balance. Most of the EEC expenditures in Spain are current transfers (subsidies) from EAGGF (FEOGA) under the Common Agricultural Policy and from ESF (FSE). Among the remaining expenditures, capital transfers from ERDF (FEDER) are the most relevant item. To the extent that non-agricultural projects are met by ERDF and ESF in a given fraction of the total cost, the EEC budget may have favored investment in basic infrastructure. This effect is likely to strenghthen in the 1990-1992 period as structural funds expand after the Council agreement on budget discipline (February 1988). However, given both the lack of sufficiently redistributive criteria in project financing and the limited size of resources managed by the Community[24] -about 1 per cent of GDP and 3 per cent of general government expenditure-, significant reductions in Spain's basic infrastructure deficiencies cannot be expected from EEC policies.

Data contained in Table 3 and recent estimates of the

TABLE 15: THE COMMUNITY BUDGET: BILATERAL FINANCIAL FLOWS SPAIN-E.E.C.
(in per cent of GDP)

	1986	1987	1988[2]	1989[3]
I. CONTRIBUTION BY SPAIN[1]				
1. Tradicional "Own Resources"	0.12	0.21	0.27	0.23
2. VAT Contributions	0.20	0.15	0.30	0.40
3. GNP Contributions	-	-	0.08	0.11
TOTAL	0.32	0.36	0.65	0.74
II. COMMUNITY EXPENDITURE IN SPAIN				
1. EAGGF[4]-Guarantee	0.15	0.30	0.65	0.53
2. EAGGF-Guidance	-	0.01	0.04	0.05
3. ERDF[5]	0.13	0.13	0.18	0.20
4. ESF[6]	0.07	0.10	0.13	0.15
5. Other	0.00	0.00	1.01	0.02
TOTAL	0.35	0.54	1.01	0.95
III. FINANCIAL BALANCE	0.04	0.18	0.36	0.20

Sources: A. Gallego y M. Sebastiá, Historia presupuestaria de la adhesión de España a las Comunidades Europeas, Instituto de Estudios Fiscales, Madrid, 1989.

Notes: 1 Net contributions to the EEC Budget
2 Estimate.
3 Budgetary forecast (nominal GDP growth assumed to be 8.4 per cent).
4 European Agricultural Guidande and Guarantee Fund.
5 European Regional Development Fund.
6 European Social Fund.

structure of general government disposable income[25] indicate that distances with respect to the EEC standards of social expenditures and infrastructure outlays have not been significantly shortened over the 1985-1988 period. Expenditure in goods and services gained 0.4 percentage points of share in GDP, an amount which was devoted to housing and collective services (0.2 per cent), gross investment (0.1 per cent) and education (0.1 per cent). General public services and health actually lost some share and national defense remained in 1988 at its 1985 level.

Government expenditure plans up to 1992 were made public when submitting a medium-term macroeconomic and fiscal scenario that accompanied 1989 Budget proposals to the Parliament[26]. Assuming a moderate slowdown of GDP growth to 4.4 per cent and a steady reduction in the inflation rate to 3 per cent, total expenditure is projected to rise 1.3 points of GDP between 1988 and 1992. Pensions (0.6 percentage points of GDP share), infrastructures (0.5 percentage points), education (0.4 percentage points), transfers to Territorial governments (0.3 percentage points) and health (0.2 percentage points) are expected to benefit both from a substantial increase in the total tax ratio (4.3 points of GDP in four years, evenly distributed across direct taxes, indirect taxes and social security contributions) and a slowdown in subsidies and capital transfers (1.1 GDP percentage points) and public debt interest payments (0.3 per cent of GDP). Unexpected fiscal events previouly mentioned could significantly alter in practice these expenditure priorities, regarding mostly to pensions, infrastructures and interest payments.

Privatization

In order to get some grasp of the role and the relative performance of the public enterprise in Spain, Table 16 arranges

TABLE 16 : ROLE OF THE PUBLIC ENTERPRISE IN THE SPANISH ECONOMY IN 1985

	Absolute value	Share in National Economy (%)
1. Employment (employees)	400.000	4.5 (EEC 4/12.3)[1]
. INI (63 firms)	187.000	
. INH (7 firms)	21.000	
. DG Patrimonio (14 firms)	19.000	
. Telefónica	66.000	
. Renfe	60.000	
. Financial enterprises	56.000	
. Other	11.000	
2. Value Added (billion ptas.)	2.534,2	10.6
. Communications	533,2	100.0
. Tobacco	225,0	100.0
. Transport by sea and air	150,5	67.6
. Coal	60,0	36.9
. Oil	210,2	36.9
. Electricity	250,0	28.4
. Metallic minerals	126,2	26.1
. Automobiles and transport materials	156,9	21.4
. Commerce and repairs	539,6	13.2
. Other	282,8	1.7
3. Production (billion ptas.)	5.458,4	10.0
4. Wages (billion ptas.)	1.174,3	9.1
5. Gross Fixed Investment (billion ptas.)	834,4	15.9 (EEC 4: 27.7)[1]
6. Economic and Financial Ratios (%)		
. Growth in sales	6,9[2]	11.7[3]
. Growth in exports	6,2[2]	9.5[3]
. Growth in value added	6,2[2]	11.0[3]
. Net profits/Net assets	- 2,1[2]	6.1[3]
. External financial expenses/Production	12,6[2]	7.2[3]
. Subsidies/Production	7,3[2]	0.2[3]
. Capital transfers/Gross fixed investment	17,0[2]	6.1[3]

Sources: Ministerio de Economía y Hacienda, El Sector Público Empresarial 1985, Madrid, 1987; P. Ortiz y A. Gómez, "La Empresa Pública en el Contexto de la Contabilidad Económica", Papeles de Economía Española, 38, 1989; Central de Balances (Banco de España), Análisis Económico-Financiero 1984-85, Vol. I., Madrid, R. Myro "Las Empresas Públicas", en J.L. García Delgado (dir), España, Vol II: Economía, Espasa-Calpe, Madrid, 1988; own calculations.

Notes:
1 1982 (weighted average)
2 Public enterprises
3 Private enterprises

a set of relevant indicators. Compared to the EEC average, the relative weight of public enterprises in the Spanish economy in 1985 was quite small. Public enterprise shares varied greatly between sectors. In terms of value added, the public share in 1985 exceeded 25 per cent in communications, tobacco, transport (by sea and air), coal, electricity, mining and metallic minerals.

In 1985, at the same time that other liberalization measures were adopted (financial system, insurance, foreign capital transactions and internal commerce[27]), deregulation of public monopolies required by EEC policies was implemented (oil products, telecommunications, tobacco and television) and a privatization programme was launched.

As a result of the oil crisis of the mid-seventies, INI, Spain's largest holding company, was used as an escape valve, as it absorbed employment and activities from failed or bankrupt enterprises. Losses mounted rapidly, reaching almost 1 per cent of GDP in 1983, with the burden of financing largely falling on the budget. The need to rationalize the public sector enterprise sector led to adoption of important policy decisions. Absorption of private firms halted, employment was reduced, growth in wages was contained, financial management was restructured and a process of retrenchment in some areas -those where government involvement was not seen as essential- was started.

Privatization in Spain has taken two routes: sale of total ownership to private concerns (Secoinsa, SKF Española, Viajes Marsans, Entursa, SEAT, ISSA, CABSA, PAMESA and MADE are some of the most significant among more than thirty sales affecting about 25 thousand employees) and sale of minority holdings through the stock exchange (GESA, ENCE, ENDESA and REPSOL)[28]. While this open process has not been as far reaching as in other countries, it can be said that both the financial position of the public sector and the efficient allocation of resources have benefited from privatization and restructuring of the public enterprise sector.

B. OUTSTANDING DISTORTIONS AND EEC INTEGRATION

Taxation disincentives and economic performance

Analysis of the consequences of legal tax provisions and increased levels of taxation is crucial to any comprehensive assessment of the impact of the Spanish public sector upon economic performance. This is particularly true in the context of convergence towards the Internal Market, since the domestic detrimental effects of taxation will be compounded by risks of tax base flight.

As Tables 11 to 13 above show, social security contributions in Spain are high relative to EEC standars (despite some reductions operated in recent years), personal income taxation is relatively small (although strong increases have taken place over the 1985-1988 period) and corporate taxation is light (due to the extension of tax credits). This tax mix is particularly relevant in a situation of high unemployment. On the one hand, there is evidence that the demand for labor is highly sensitive to changes in the real wage and the relative labor cost[29]. On the other hand, empirical work has found a surprisingly high impact of the rise in the tax wedge on labor upon the increase in NAIRU in the first half of the eighties[30].

Detrimental employment effects of an increased tax wedge were somewhat cushioned in the 1979-1984 period by reductions in the take-home pay. However, this has not been the case in the 1984-1987 period, over which gross earnings and take-home pay of the average production worker have grown at broadly similar rates.

This is precisely the time in which marginal tax rates on incomes earned by an average production worker increased the most since the income tax was introduced in 1979[31]. Once account is taken of the fact that social security contributions have remained relatively stable in recent years and that the average effective marginal rates on capital incomes have been experiencing important reductions since 1979 (from more than 36 per cent to less than 5 per cent in 1986[32]), it can be safely concluded that tax policy has not positively contributed to the expansion in employment observed over the 1986-1989 period.

Rising marginal income tax rates may have had a non-negligible effect on labor supply as well. Evidence suggests that a major channel of detrimental effects upon labor supply is the negative relationship found between marginal tax wedges and female participation rates[33], compounded by income accumulation under the personal income tax -recently declared unconstitutional- and the relatively strong effect of the inflationary fiscal drag upon marginal tax rates[34]. A different potential source of distortions of labor supply decisions comes through the combined impact of changes in social security contributions and expectations of future pensions upon retirement decisions. Empirical work has found a positive effect of these (i.e. the income effect of increases in contributions counterbalances both the negative substitution effect and the negative income effect of pensions), although quite small in magnitude[35].

The structure of marginal tax rates is also relevant to 'black economy' and tax evasion decisions. Available studies indicate that about 27 per cent of workers did not pay social security contributions in 1986[36]. In this same year, some 36 per cent of liable tax units under the personal income tax did not submit tax returns and non-declared incomes were estimated in 45 per cent of the potential

TABLE 17: PERSONAL INCOME TAX IN THE E.E.C.
TAX RATES AND OTHER ASPECTS

	Tax Rates[1]		Tax	Tax Unit[2]		Double Taxation of[3] Dividends: Degree
	Minimum	Top	Elasticities	Individual	Family	of Correction (%)
Germany	22	56	1.63	Option	Splitting	100.0
Belgium	25	75	1.48	-	Spec.rules	66.3
Denmark	45	68	1.37	x	-	33.3
Spain	25	56	1.78	Option	Spec.rules	18.6
France	9	56.8	n.a.	-	Quotient	69.0
Greece	18	50	1.72	x	-	100.0
Netherlands	14	72	1.70	x	-	0.0
Ireland	35	58	1.55	Option	Spec.rules	60.7
Luxembourg	10	56	n.a.	-	Quotient	0.0
Portugal	16	40	n.a.	-	Credit	24.2
U. Kingdom	25	40	1.52	Option	Spec.rules	61.9

Sources: E. Albi, "España y las corrientes reformadoras de la fiscalidad", Universidad Complutense (Cursos de Verano), mimeo, 1989; J.M. González-Páramo, "La integración de los impuestos personal y societario en los países desarrollados: Lecciones del análisis comparado", Documento de Trabajo, 9/88, Instituto de Estudios Fiscales, Madrid; I. Argimón and J. Marín, "La progresividad de la imposición sobre la renta", mimeo., 1989.

Notes: 1 Includes local taxes.

2 Account is taken of the Spanish government proposal to adapt legal provisions to the Constitutional Court ruling on joint taxation.

3 Correction is achieved through imputation of tax credits (Belgium, Denmark, Spain, France, Ireland, Italy and United Kingdom), deduction of dividends paid from corporate taxable income (Greece), different tax rates on dividends and retentions (Portugal) and a mix of imputation and different tax rates (Germany). Luxembourg and the Netherlands do not provide relief for double taxation of dividends.

tax base[37]. While recognizing the relevancy of factors other than the tax rate as to the tax evasion decision (source of income, family status, probability of audit, size of penalties and the like), available evidence suggests that increased real progressivity of the personal tax wedge has stimulated underdeclaration[38].

Relatively strong progressivity of the personal income tax and a low degree of compensation for double taxation of dividends (see Table 17), compounded with the impact of inflation and heavy taxation of capital gains, have been blamed for their harmful impact upon incentives to save. Despite the empirical difficulties for the assessment of this relationship, there is some evidence indicating that direct household taxes have exerted a bias against household savings[39]. Composition of saving may have been also influenced by tax provisions which establish differential treatment across types of assets. Treasury bills, public debt, new share issues, insurance contracts, housing bank accounts, house acquired with mortgage and investment funds have enjoyed over time substantial degrees of fiscal privilege. Finally, it is worth mentioning that the overall impact of social security contributions and expected pensions on personal savings has been found significant, although the estimated magnitude of this effect varies widely[40].

While there is some agreement that there has been a positive short-run response of private investment to tax incentives[41], doubts exist as to whether capital formation decisions have been merely brought forward in time. Whatever the real impact of taxes on capital accumulation might have been in the past, overall assessment of investment tax incentives on efficiency grounds must be undoubtedly negative for two reasons. In the first place, the existence of a capital shortage in the Spanish economy is not a market failure to be solved by means of selective help to investment. On the contrary,

TABLE 18: CORPORATE TAXATION IN THE E.E.C.: NOMINAL AND EFFECTIVE TAX RATES
(percentage points)

	Nominal[1] Tax Rates	Effective Marginal Tax Rates[2]		Total Tax Allowance[3]	
		Equipment	Structures	Equipment	Structures
Belgium	43	-51.5	-9.4	44.8	29.2
Denmark	50	-6.0	-4.8	22.2	12.9
Spain	35	-16.1	-6.3	32.9	26.2
France	42	-25.1	-20.8	35.4	22.2
Greece	39/49	-	-	-	-
Netherland	40	15.2	35.1	41.0	24.0
Ireland	50	-313.3	-246.2	55.0	55.0
Italy	36	-48.2	-50.4	24.2	12.9
Luxembourg	20/36	-	-	-	-
Portugal	30/35	-	-	-	-
Germany	36/56	-47.2	-23.1	48.4	27.5
U. Kingdom	35	-101.2	-69.0	52.0	41.4

Sources: Price Waterhouse, Corporate Taxes: A Worldwide Summary, London 1988; M.J. McKee, J. Visser and P. Saunders, "Marginal Tax Rates on the Use of Labour and Capital in OECD Countries", OECD Economic Studies, 7, 1986, pp. 45-101.

Notes: 1 Greece uses different rates for commercial and industrial firms (dividend distributions are not taxed); Luxembourg and Portugal apply a progresive schedule; Germany taxes dividend distributions at a low rate (36 per cent).

2 Ratio of the wedge between pre- and post-tax rates of return to the pre-tax rate of return on the marginal investment. Rates are computed for a 10% pre-tax return investment financed through new equity issues. It takes into account tax savings from depreciation allowances, investment credits, special taxation of capital gains and other features of the tax system.

3 The difference between statutory tax rates and capital tax allowances indicates the degree to which the system of capital allowances by it self is neutral: allowances smaller than the tax rate indicate that capital formation is taxed, and viceversa.

if present capital shortage results from monopoly power in both labor and product markets, the appropriate policy should be subsidization of both capital and labor paid for with a tax on supernormal profits[42]. Secondly, had the adoption of more labor-intensive techniques counterbalanced past reductions in capital accumulation, unemployment would not have mounted to the 1985 daunting levels. However, increased wage pressure in the second half of the seventies, rising tax wedges on labor income and sharp reductions in marginal tax rates on capital have worked precisely in the opposite direction. In such a context, investment incentives could prove an obstacle to recovery of employment to the extent that they favor the adoption of more capital-intensive techniques, thus hampering welfare gains accruing from wage moderation.

An entirely different source of non-neutrality is brought about by the impact of tax provisions upon the components of capital cost. Depreciation allowances, investment credits, tax treatment of capital gains, taxation of inventories, loss compensation for tax purposes and the like distort decisions relevant to the type of asset chosen , the sector of investment and the source of finance. Available evidence shows that the Spanish corporation income tax causes considerable diversity in marginal tax rates on projects yielding equal pre-tax returns[43]. As Table 18 indicates, statutory tax rates bear no direct relationship with marginal effective tax rates. Corporate taxation tends to subsidize hypotetical marginal projects, particularly so with regard to investment in equipment. Although not shown in the table, it is worthwhile mentioning that Spain in one of the EEC countries where marginal tax rates (subsidies) on investment vary more widely across sources of finance[44].

Preceeding considerations are relevant for the Spanish economy when considered in isolation from other European countries. Increased integration of Spain's goods markets and capital markets

-started in 1986 and to be completed by 1992- brings into the analysis further considerations. In the first place, it has been widely acknowledged that substitution of VAT for a previously existing set of indirect taxes removed hidden subsidization of exports and tax protection of imports. Important as this policy decision has been, if Spain is to exploit comparative advantage in the production of relatively labor-intensive products as tariff and non-tariff barriers are being removed, relative wage and non-wage labor costs have to be kept down. This calls for both wage moderation and reluctance to overburden labor with excessively large tax wedges. At the present, however, social security contribution rates in Spain are among the highest in the EEC[45] and the employer's rate -which is the portion of the tax wedge most easily shifted on to prices- is the largest. Potential distortive effects of this non-wage labor cost disadvantage could be cushioned by reductions in employers contributions. An increase in VAT rates could make up for the ensuing revenue loss.

Removal of restrictions to capital movements across EEC countries makes inter-country differences in systems of capital income taxation a potential source of heavy distortions and tax base flight. In a world with perfect capital mobility, capital export neutrality (equality of real after-tax yields from investing domestically or abroad) obtains only if tax bases share the same definition, if authorities' control of international capital transactions for tax purposes is perfect and if double taxation of foreign income is avoided through appropriate tax credits in the home country or tax exemptions in the host country. Under tax-adjusted covered interest parity, deviations from these extreme assumptions will cause changes in financial policies and reallocations of capital away from countries where capital income is heavily taxed domestically and where control of capital income from abroad for tax purposes is lax, thus pushing towards convergence of effective marginal tax rates[46].

Provided that there is not substantial progress in the harmonization of systems of capital income taxation in the short run, the tax treatment of dividends and capital gains under the present tax provisions and double taxation treaties opens up interesting profits opportunities from investing abroad, even if compliance is perfect. Once imperfections in tax enforcement are accounted for, differences in withholding rates play a crucial role in explaining financial arbitrage and cross-country investment decisions. As Table 19 shows, although withholding rates on interest and dividends paid by Spanish enterprises to non-residents are not among the EEC highest, they are not the lowest either.

Adverse consequences of expenditure growth and indebtedness

To the extent that expansion of public expenditure has provided economic and social capital as well as social equity and political stability, it must be acknowledged that the growth of government has positively influenced the well-being of the population. Furthermore, as empirical assessment shows, public expenditures are much more effective as redistributional mechanisms than taxes can be[47].

It can be argued, however, that this beneficial role is not a free good to society. Alleviation of poverty or public provision of housing, for example, have two elements of cost. First, resources are taken away from alternative private directly-productive uses. Second, government involvement tends to jeopardize basic behavioral norms, price signals, returns to innovation and investment and, hence, economic dynamism.

General assessment of these costs are difficult once public intervention is dissagregated. Notwithstanding, pieces of

TABLE 19: CORPORATE INCOME TAXATION IN THE E.E.C.:
WITHHOLDING TAXES ON INTEREST AND DIVIDENDS
(percentage points)

		HOME COUNTRY [2]											
HOST COUNTRY [1]		B	DN	S	F	GR	IR	IT	LX	N	PO	GER	U.K.
Belgium	D	25	15	15	10/15	15	15	15	10/15	5/15	15	15	15
	I	25	0/15	0/15	0/15	0/10	0/15	0/15	0/15	0/10	0/15	0/15	0/15
Denmark	D	30	30	10/15	0	30	0	15	5/15	0/15	10/15	10/15	0/15
	I	0	0	0	0	0	0	0	0	0	0	0	0
Spain	D	15	10/15	25	10/15	20	20	15	10/15	10/15	10/15	10/15	10/15
	I	15	10	25	10	20	20	12	10	10/15	15	10	12
France	D	10/15	0	10/15	0	25	10/15	15	5/15	5/10	15	0	5/15
	I	15	0	10	0	0	0	15	10	0/10	10/12	0	0
Greece	D	25	42/53	42/53	42/53	42/53	42/53	25	42/53	35	42/53	25	42/53
	I	15	46	46	10	25/8	46	10	46	10	46	10	0
Ireland	D	0	0	0	0	0	0	0	0	0	0	0	0/15
	I	15	0	35	0	35	0/35	10	0	0	35	0	0
Italy	D	15	15	15	15	25	15	10	15	0/32.4	15	32.4	5/15
	I	15	15	12	15	10	10	10/30	10	15/30	15	0/15	15/30
Luxembourg	D	10/15	5/15	5/15	5/15	15	5/15	15	15	25/15	15	10/15	5/15
	I	0	0	0	0	0	0	0	0	0	0	0	0
Netherlands	D	5/15	0/15	5/15	5/15	5/15	0/15	0	2.5/15	25	25	10/15	5/15
	I	0	0	0	0	0	0	0	0	0	0	0	0
Portugal	D	12	10/12	10/12	12	12	12	12	12	12	25	12	10/12
	I	15	15	15	12	15/25	15/25	15/25	15/25	15/25	20	15	15/25
Germany	D	15/25	15/25	15/25	15/25	25	15/20	25	15/25	15/25	15/25	25	15/25
	I	0	0	0	0	10	0	0	0	0	10	10	0
U. Kingdom	D	0	5/15	0/15	0/15	0	0/15	0	5/15	5/15	0	0	0
	I	15	0	12	0	0	0	25	0	0	10	0	25

Sources: M.V. Román and J.A. Rozas, "La tributación de las rentas del capital en los estados miembros de la Comunidad Europea", Instituto de Estudios Fiscales, Papeles de Trabajo, 12/89, may, 1989; Price Waterhouse, Corporate Taxes: A Worldwide Summary, London, 1988.

Notes: 1. D: dividends; I: interest.
2. Low rates apply to non residents and/or to payments made by subsidiaries.

evidence exist that establish a negative relationship between productivity or growth potential and the size of public expenditure. On the one hand, growth rates in total factor productivity have been usually smaller in social and collective services than in the rest of the economy in most developed countries over the 1970–1983 period[48]. On the other hand, to the extent that the government's use of labor and capital to produce goods and services and redistribution can be proxied by government expenditure shares in GDP, a production function approach can be used to estimate the 'price' of public sector growth in terms of productivity losses or output foregone.

Table 20 summarizes the results of an empirical study which follows the production function approach. According to these calculations, the cost of government expansion has been about 1.4 percentage point of GDP growth on average between 1974 and 1987, which amounts to a 60 per cent offset of the contribution to output growth of total factor productivity. This result is consistent with the the available international evidence[49].

Alternative ways exist to reduce such a large cost. First, the most effective means of enhancing competitiveness and rising potential output is expenditure restructuring towards infrastructure[50]. This needs not imply an increase in total spending if additional resources come from reduced expenditure in economic services or from a more cost-effective oriented management of resources allocated to other public projects. Second, government could retrench from sectors in which social goals can be met by public provision without direct public production. A mix of regulation and financial agreements with private sector agents is a good substitute for public production in some social services, like education and health.

Third, income maintenance expenditures could undergo 'productivity' oriented changes. Thus, for example, unemployment

TABLE 20: GOVERNMENT SIZE AND ECONOMIC GROWTH IN SPAIN
(average real growth rates)

	1970/74	1974-87	Difference
1. FACTOR USAGE	2.5	1.0	1.5
Capital	2.3	1.4	-0.9
Labor	0.2	-0.4	-0.6
2. RESIDUAL FACTOR	3.7	0.9	-2.8
Total Factor Productivity[1]	4.1	2.3	-1.8
Government Size[2]	-0.4	-1.4	-1.0
3. GDP GROWTH (1+2)	6.2	1.9	-4.3

Sources: J.L. Raymond, "Productividad de los factores y expansión del sector público en España", Fundación FIES-CECA, Documentos de Trabajo, 40, april, 1989.

Notes: 1 Weighted contribution of capital and labor productivity increases to GDP growth.

2 Government size is proxied by the share of general government purchases of goods and services and transfers to the private sector in GDP.

benefits could bear a closer relationship with employment promotion activities (mismatch reduction, recycling and so on) and postponement of retirement could be encouraged through higher pension benefits. A final suggestion has to do with effectiveness of expenditure management and control. This calls for increased efforts in audit controls and recommends avoiding precommitments. Political compromises that enhance fiscal responsibility would work in the same direction. Examples of this sort of compromise are the subordination of expenditure increases to reductions in tax evasion or the concession of increased tax powers to the Territorial governments.

With regard to debt dynamics, although the debt-GDP ratio is smaller in Spain than in the average of the EEC countries, its adverse economic consequences should not be played down. As pointed out above, the rise in the share of public debt in GDP has been very rapid. As a result, interest expenditure expansion has squeezed other components of expenditure for a given level of fiscal restraint. This makes increasingly hard to achieve further budget restraints, as the ongoing boom of economic activity and EMS membership would require.

Budget inflexibility resulting from the increased burden of the debt service is compounded by other potential sources of preoccupation. A high debt-GDP ratio makes public sector accounts highly vulnerable to foreign interest rate shocks as capital mobility becomes more important. Risks of unstable episodes with brisk debt jumps cannot be ignored even if primary superavits obtain on a permanent basis and rates of economic growth are high if non-accomodating monetary policies cause interest rates to exceed nominal GDP growth. This has been precisely the Spanish situation since the early eighties. Debt explosion has been prevented due to both the shield provided by compulsory investment by financial institution in low-yield securities[51] and the reductions in the primary deficit operated between 1985 and 1988. As reserve and investment requirements converge toward EEC standars, the risks of debt instability will become more apparent. A different adverse effect of increasing debt issues has to do with rising real interest rates and the ensuing 'crowding out' of investment and external demand. Finally, high and rising debt ratios hamper disinflationary policies to the extent that this gives rise to expectations of future expansions in the money stock.

C. ADJUSTING TO THE 1992 SHOCK

Domestic policies: constraints and strategies

As 1992 comes more close, removal of physical, technical and fiscal barriers will enable the EEC to reap the benefits of the Single Market. Increased competition will generate benefits and costs whose distribution across countries will depend on both comparative advantage and adjustment policies adopted in the domestic and the Community levels.

Appropriate domestic policies should be designed so as to maximize gains from enhanced competition in goods and factor markets in an environment constrained by domestic objectives and Community--wide restrictions. Outstanding among the later are the abolition of barriers to goods transactions and capital movements, recent EMS membership and differences in taxation of goods and capital incomes. The most prominent domestic objectives are those related with the need to maintain and finance relatively large rates of growth in investment -as a means of increasing competitiveness and reducing unemployment associated to the shortage of capital- and the challenge to improve social services and infrastructure.

Under EMS, expansionary fiscal policy will prove costly, now and as 1992 approaches. Provided that anticipation of EMS membership to June 1989 largely responds to the convenience of borrowing reputation from linking the Spanish Pta to the German DM in order to facilitate disinflation, maintaining an expansionary fiscal stance could hamper pursuance of this objective. This would be the case if appreciation of the nominal exchange rate[52] gives rise to expectations of downward realignments of the Pta.

There are further arguments that would recommend the adoption of a more restrictive fiscal policy. To the extent that budget-induced expansions generate increases in home prices relative to those of foreigners, expansionary fiscal policy damages competitiveness. Investment crowding-out may also obtain, although in a lesser degree than in the presence of restrictions to capital mobility. Expectations of future tax increases to eliminate present deficits could induce capital flights, thus making more difficult to finance fiscal imbalances by means of domestic resources. In such a context, the external sector restriction could seriously impair investment and growth. As Table 21 shows, resort to foreign savings has increased by 2.8 percentage points of GDP between 1986 and 1988. Continuation of this process seems unlikely, as recent capital balance forecasts point out[53].

Changes in tax revenues and tax policy are necessary in order to eliminate further constraints in the operation of fiscal policy. With national monetary policy essentially tied to maintaining exchange rate stability, the Spanish fiscal authorities will not have access to deficit financing by the central bank. As Table 22 indicates, between 1979 and 1986 resources obtained through seignorage amounted to 1.8 per cent of GDP on average. A reduction of this tax on money balances to the average share of seignorage in GDP of EMS

TABLE 21: SAVING AND INVESTMENT
BALANCES OF THE SPANISH ECONOMY
(per cent of GDP)

		1980-84	1985	1986	1987	1988
(1)	TOTAL DOMESTIC SAVING	19.4	20.4	21.5	21.8	22.7
	Private saving	19.6	21.9	21.9	20.4	20.9
	Household	8.6	8.5	8.1	7.9	8.2
	Business	11.0	13.4	13.8	12.5	12.7
	Public saving	-0.1	-1.4	-0.5	1.4	1.8
(2)	GROSS INVESTMENT	21.0	18.8	19.8	21.8	23.8
(3)	CURRENT EXTERNAL BALANCE (=foreign saving with opposite sign)	-1.5	1.6	1.7	0.0	-1.1

Source: OECD, OECD Economic Surveys: Spain, Paris, may, 1987.

TABLE 22: SEIGNORAGE AND TAX REVENUES [1]
(per cent of GDP; in brackets, per cent of total tax revenues)

EEC 1979-1986 [2]

EEC (12)	EEC (10)	EMS Countries	Non EMS Countries
1.0	0.9	0.9	1.3
(2.4)	(2.0)	(2.1)	(3.6)

SPAIN 1979-1988

1979-1986	1985	1986	1987	1988
1.8	1.9	1.7	2.0	0.6
(5.9)	(5.5)	(4.8)	(5.4)	(1.8)

Sources: OECD, Economies in Transition: Structural Adjustment Experience in OECD Countries, Paris, july, 1988, mimeo; Banco de España, Informe Anual and Boletin Estadistico, 1985-1988; own calculations.

Notes: 1 Change in the monetary base as a percentage of GDP.

2 Weighted averages (1985 GDP weights and exchange rates)

countries will entail a revenue loss close to 1 per cent of GDP.

Other taxes must be changed so as to make up for this loss while providing resources for additional expenditure needs. In the present stage of the tax harmonization process, the constraints posed by the exigency to counterbalance the insufficient level of domestic saving without impinging upon employment suggests three main sources of additional tax revenues: increases in VAT and excise tax rates, improvements in compliance levels and reductions in tax expenditures.

Prevention of tax base flights recommends unilateral changes in the taxation of capital income in those aspects where Spain is at a relative disadvantage (taxation of capital gains in personal and corporate taxes, double taxation of dividend income, tax treatment of inventories and loss compensation, among other aspects). Employment growth and comparative advantage exploitation suggest the convenience of restructuring social security contributions through reductions in the employer's contribution rate and the progressive elimination of contribution base ceilings.

On the expenditure side, positive adjustment to the 1992 shock demands both a reinforcement of specific expenditure priorities and improvements in efficiency and effectiveness. As regards to priorities, the extent to which the benefits of the Internal Market will be reaped hinges upon the degree of success in the suppression of actual and potential bottlenecks created by infrastructure defficiencies, even at the cost of reductions in other expenditure programmes. And above all, this priority should not be at risk whenever other expenditure needs put a pressure upon the political authority. Given that expenditures in pensions, education and health care are expected to rise faster than GDP over the 1989-1992 period due to precommitments under ongoing programmes, additional resources for infrastructure improvement should come from other expenditure items -in particular interest, price subsidies and capital transfers-, from further sales of public assets and from increased taxation. Outlook for doubling of capital transfers from the EEC to two-thirds of GDP in 1992 will have beneficial effects as to the infrastructure priority.

Room for improvement in efficiency and effectiveness of government expenditure policies is substantial. Effectiveness enhancement could come from a variety of sources: elimination of the possibility of obtaining large amounts of cash finance from the central bank (see Table 23), introduction of cost-benefit and cost-effectiveness criteria in project selection and management, change in institutional features that favor laxity in the execution of the budget (concession of supplementary credits and employment of unused appropriations) and avoidance of precommitments where possible. On the other hand, efficiency gains may be obtained in the medium term from retrenchment from sectors in which social goals can be met by regulation without public production (health and education), reductions in price subsidies and capital transfers and introduction of productivity criteria in income maintenance expenditures (pensions and unemployment subsidies).

Strategy towards Community policies

Spain should promote policy coordination among EEC member countries. Given the distances that exist in living standards, social policy achievements and infrastructures, the alternative of favoring a purely competitive strategy is not a reasonable option for Spain. On the other hand, a strategy of 'follower country' -ignorance of Community processes and acceptance of Community decisions upon negotiation of compensations- would not yield long-term pay-offs,

TABLE 23: DEFICIT FINANCING BY CENTRAL BANKS IN THE EEC COUNTRIES

	Limits on Non-Interest Borrowing	Interest Bearing Titles Non-Market	Market	Regulation of Non-Market Lending
Germany	Quantitative (low)	Not permitted	Open market operations only	Parliamentary approval
Belgium	Quantitative (high)	Included in the former limit	No limit	Central Bank-Treasury agreements
Denmark	Proportion of total appropriations (high)	Included in the former limit	No limit	Central Bank-Treasury agreements
Spain	Proportion of total appropriations (high)	No limit	No limit	Parliamentary approval
France	Quantitative (low)	Not permitted	No limit	Parliamentary approval
Netherlands	Quantitative (low)	Special limit	No limit	Central Bank-Treasury agreement
Italy	Proportion of total appropriations (high)	Not permitted	No limit	Parliamentary approval
U. Kingdom	Not permitted	Not permitted	No limit	—

Sources: E. Fernández and F. Gutiérrez, "La financiación del Tesoro por los bancos centrales en los bancos centrales en los principales países de la CEE", Boletín Económico, Banco de España, september, 1987.

given Spain's level of development and growth potential.

It is only through policy coordination that an equitable sharing of benefits and costs of the Internal Market can be expected in the Community. This is not to say that coordination is a 'sine qua non' condition for a particular country to gain from 1992. However, the role of coordination is not just instrumental but political as well. It is instrumental to the extent that coordination provides cushions against shocks in the process ending at the Internal Market. It is political in the sense of ensuring equity and social cohesion in a context of countries which do not conform a political union.

Loss of discretionary powers to pursue domestic objectives through public expenditures and fiscal policy should call for a greater role given to the EEC Budget as a means of allocating resources and redistributing incomes between EEC citizens and EEC regions. As the costs of removal of barriers are expected to spread unevenly across regions and countries, so should an increased amount of EEC funds be allocated to compensate those effects in such a fashion that incentives to withdraw from the integration process are eliminated. A more equitable distribution of countries' shares in the financing of the EEC Budget would work in the same direction.

Stabilization of income and employment is not presently a function of the EEC Budget, although some stabilization role would be defensible. As EMS membership entails doing away with a cushioning mechanism against recession (i.e. depreciation of the exchange rate), the limited room that 1992 will leave for autonomous discretionary domestic fiscal policies would recommend the creation of EEC stabilization subsidies and transfers, in order to make the Monetary Union a more viable project.

With regard to the revenue side, Spain should promote tax harmonization along the lines devised in the recent Commission proposals. Although tax harmonization is not always seen as necessary in the context of political federations, the absence of substantial harmonization of product and factor taxes could impinge upon the objectives of the Internal Market. Proposals that defend alternative arrangements, such as mutual assistance and the like, ignore the foremost instrumental and political importance of tax harmonization for economic and social cohesion.

Therefore, as much as possible, differences in tax bases and rates of VAT and excises should narrow across countries if the adoption of an origin principle of taxation simultaneous with the elimitation of physical barriers is to succeed in avoiding trade distortions along with fiscal fraud. As much as possible, tax bases and withholding rates of corporate income taxation should be harmonized if the commitments to exchange-rate fixity and unrestricted capital mobility are not to be challeged [illegible] tax competition, international tax evasion and perceptions of an unfair distribution of the gains from increased competition.

NOTES AND REFERENCES

1. See P. Muller and R.W. Price, "Structural budget deficits and fiscal stance", OECD Working Papers, 15, Paris, July 1984.

2. A recent empirical analysis that establishes the link between fiscal policy, real activity and inflationary expectations is provided by F. Ballabriga, "Empirical macroeconomic modelling of the Spanish economy", Dirección General de Planificación (Ministerio de Economía y Hacienda), Madrid, mimeo., February 1989.

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9. Ministerio de Educación, Proyecto para la reforma de la enseñanza, Madrid, 1987, and OCDE, L'enseignement dans les pays de l'OCDE, Paris, 1988.

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11. OECD, Financing and delivering health care, Paris, 1987.

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25. J. Alcaide, "La distribución de la renta española en la década de los ochenta", Documentos de Trabajo, 38/1989, Fundación FIES-CECA, 1988.

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27. For a synthesis, see A. Costas and J.M. Serrano, "Las reformas institucionales. Impulsos y resistencias", Revista de Economía, 1, pp. 63-68, 1989.

28. See Z. Fernández, "El alcance del proceso privatizador en España", Papeles de Economía Española, 38, pp. 243-246, 1989.

29. J.L. Raymond, J. García and C. Polo ("Factores explicativos de la demanda de empleo", Papeles de Economía Española, 26, pp. 180-195, 1986) find an elasticity of substitution between capital and labor of 0.5. Cross-section estimates of the substitution elasticities in the industrial sector range from 0.2 to 0.7 (See L. Rodríguez Romero, "Elasticidades de sustitución entre inputs primarios en las grandes empresas industriales españolas", Investigaciones Económicas, XI, pp. 399-426, 1987).

30. See J.J. Dolado, J.L. Malo de Molina and A. Zabalza, "El desempleo en el sector industrial", Papeles de Economía Española, 26, pp. 158-179, 1986.

31. OECD, The tax/benefit position of production workers, Paris, 1988.

32. M. Espitia, E. Huerta, G. Lecha and V. Salas, "Impuestos efectivos sobre beneficios y rentas de los activos productivos", Papeles de Economía Española, 39/40, pp. 433-450, 1989.

33. J. García, J.M. González-Páramo, "El coste de eficiencia de la tributación familiar en España", Moneda y Crédito, Segunda Epoca, 1 (forthcoming).

34. I. Argimón and J.M. González-Páramo, "Una medición de la rémora inflacionaria en el IRPF, 1979-1985", Investigaciones Económicas, XI, pp. 345-366; and T. Valdés, J.L. Raymond and J.L. Argimón, "Evolución de la recaudación en el IRPF: Determinación de las causas y estimación de los efectos", Investigaciones Económicas, XIII, pp. 14-44, 1989.

35. See A. Martín and L. Moreno, "Efectos de las pensiones de la seguridad social sobre la oferta de factores: trabajo y ahorro", Documentos de Trabajo, Fundación FIES-CECA, 42/1989.

36. See J. Muro, J.L. Raymond, L. Toharia and E. Uriel, Análisis de las condiciones de vida y trabajo en España, Secretaría de Estado de Economía (Ministerio de Economía y Hacienda), Madrid, 1988.

37. It must be pointed out that compliance has been remarkably boosted over the 1984-1986 period as a result of tax administration increased efforts. See M. Lagares and others, "Evaluación del fraude fiscal en el IRPF en los ejercicios 1979 a 1986", Instituto de Estudios Fiscales, mimeo., Madrid, May, 1988.

38. See J.L. Raymond, "Tipos impositivos y evasión fiscal", Papeles de Economía Española, 30/31, pp. 154-169, 1987.

39. See J.A. Herce, "El ahorro en España, 1964-1984", Documentos de Trabajo, 8610, Fundación Empresa Pública, 1986; and J.L. Raymond, "Fiscalidad y ahorro", Papeles de Economía Española, 37, pp. 520-523, 1988.

40. See A. Martin and L. Moreno, "Los efectos..."; and S. Gómez Sala, "Efectos económicos de las pensiones públicas. Análisis del caso español", Hacienda Pública Española, 104, pp. 147-162, 1987.

41. M. Espitia, E. Huerta, G. Lecha and V. Salas ("Inversión, coste de uso del capital e impuestos en la economía española, 1965-1984", Universidad de Zaragoza, mimeo., April, 1988) find a relatively strong short-run effect of tax incentives upon investment in a Q-type model.

42. See, for example, C. Bean, "Capital shortage and persistent unemployment", Economic Policy, 8, pp. 12-44, 1989.

43. See C. Cuervo-Arango and J. Trujillo, Estructura fiscal e incentivos a la inversión, FEDEA, Madrid, 1986; and M. Espitia, E. Huerta, G. Lecha and V. Salas, "Impuestos efectivos...".

44. In 1983, dispersion was higher only in Ireland, United Kingdom and Italy (see M.J. McKee, J. Visser and P. Saunders, "Marginal tax rates on the use of labour and capital in OECD countries", OECD Economic Studies, 7, pp. 45-101, 1986.

45. See Commission of the European Communities, Comparative Tables of the Social Security Schemes in the Member States of the European Community, Brusels, 1988.

46. See J.S. Alworth and W. Fritz, "Capital mobility and the cost of capital under certainty and effective tax rates in Europe", in M. Funke (ed.), Factors in business investment, pp. 173-203, Springer-Verlag, Berlin, 1989.

47. Quantitative analysis of public expenditure incidence in Spain is done by B. Medel, A. Molina and J. Sánchez Maldonado, "Los efectos redistributivos del gasto público en España", Documentos de Trabajo, 28/1988, Fundación FIES-CECA, 1988. A survey of international evidence is provided by J. Lecaillon and other, Distribución de la renta y desarrollo económico, Chapter 6, Ministerio de Trabajo y Seguridad Social, Madrid, 1987.

48. OECD, Perspectives Economiques de l'OCDE, 42, pp. 42-51, December, 1987.

49. See, for example, E.A. Peden and M.D. Bradley, "Government size, productivity and economic growth. The postwar experience", Public Choice, 61, pp. 229-245, 1989, and references quoted therein.

50. D.A. Aschauer, "Is public expenditure productive?", Journal of Monetary Economics, 23, pp. 177-200, 1989.

51. OECD staff has computed a "aparent interest rate" of general government debt which takes into account compulsory debt financing (See OECD, "Economic Surveys..").

52. J. Viñals and L. Domingo ("La peseta y el SME: Un modelo de tipo de cambio peseta--marco", Revista Española de Economía, 2ª Epoca, 4, pp. 93-110, 1987) find a relatively small response of the nominal exchange rate to an increase in total public deficit. It is not clear, however, that this conclusion would hold for an increase in the cyclically-adjusted deficit.

53. The external sector restriction in explored in detail in Banco de España, Informe Anual 1988, Chapter 4, Madrid, 1989.